noted in Penn Central, the Court has "recognized, in a wide variety of contexts, that government may execute laws or programs that adversely affect recognized economic values" without implicating the takings clause.[69] Such is the case here. Bill-and-keep would be but one piece in a package of rules designed to facilitate the provision of competitive local exchange and exchange access services as required by Congress. Because of the limited nature of bill-and-keep, and whereas none of the other factors are implicated, the Commission need not be concerned that a reviewing court would find that bill-and-keep amounts to an unconstitutional "taking."

2. Even If Bill-And-Keep Is Found To Be A Taking For Fifth Amendment Purposes, Just Compensation Is Received And No Constitutional Rights Would Be Violated

Relying on Duquesne Light Co. v. Barasch,[70] BellSouth notes that the Fifth Amendment prevents regulatory agencies from establishing charges so low that they would be confiscatory, and concludes that a bill-and-keep requirement would not "pass constitutional muster because the LEC receives no compensation for the use of its property."[71] However, to suggest that no

[69]Penn Central, *supra* 438 U.S. at 125.

[70]488 U.S. 299 (1989).

[71]BellSouth comments at 75. See also GTE comments at 58 (stating, without support or analysis, that bill-and-keep does not meet the just compensation requirement of the Fifth Amendment.).

compensation would be received under a bill-and-keep arrangement is patently absurd.

Under a bill-and-keep system, in exchange for being able to terminate traffic on ILEC networks, an interconnector will be required to permit ILEC-originated traffic to terminate on its network. Thus, each party receives a valuable benefit. As discussed above, while not receiving an actual cash payment for terminating traffic, an ILEC's corresponding right to terminate its own traffic on the competitors' network is a tangible and valuable benefit. Thus, *assuming arguendo* that bill-and-keep would result in a "taking" of LEC property for purposes of a Fifth Amendment analysis, ILECs still do not have a valid claim because the second prong of the "taking" test is not satisfied; namely, ILECs would receive just compensation under a bill-and-keep arrangement.[72]

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[72] There is not merit to the arguments raised by some ILECs that bill-and-keep is illegal because it does not represent any payment for services . . . [T]aking the ILEC argument to its illogical conclusion would suggest that barter transactions for services have no value. The United States Internal Revenue Service, however, recognizes barter transactions in determining income tax liability under the Internal Revenue Code. Thus, payment in kind has true legal value.

Teleport comments at 68 (footnotes omitted).

VII. Section 252(i) Clearly Requires That Each Interconnection Service Or Network Element Made Available Pursuant To An Agreement Shall Be Made Available To Other Telecommunications Carriers On the Same Terms And Conditions

Ameritech offers a novel interpretation of Section 252(i) which is contrary to the language of the 1996 Act and which should be rejected by the Commission. Section 252(i) provides as follows:

> A local exchange carrier shall make available any interconnection, service, or network element provided under an agreement approved under this section to which it is a party to any other requesting telecommunications carrier upon the same terms and conditions as those provided in the agreement.[73]

Under the interpretation offered by Ameritech, this statutory provision does not afford to telecommunications carriers the right to obtain interconnection, service, or network elements on the same terms and conditions as those interconnections, services or network elements are provided to other carriers pursuant to agreement -- even though that is precisely what Section 252(i) says. Instead, Ameritech claims that this section only affords other telecommunications carriers the right "to obtain the same agreement."[74]

By its terms, Section 252(i) is applicable to interconnection, services, and network elements; it is not applicable to agreements.

[73]47 U.S.C. §252(i).

[74]Ameritech comments at 98.

Whether or not the entitlement of a telecommunications carrier to obtain specific interconnection arrangements, services, or network elements from individual agreements creates a right to "cherry pick" as alleged by Ameritech, nothing in Section 252(i) or its legislative history suggests that the subsection is not applicable to individual interconnection, services, or network elements, but only to the entirety of agreements. Because Section 252(i) gives all telecommunications carriers the right to obtain interconnection, services, and network elements at terms and conditions provided in specific agreements, irrespective of whether the carrier chooses to obtain the entirety of services and facilities pursuant to such agreements, it becomes critically important that each interconnection arrangement, service and network element be priced properly on the basis of cost as specified at Section 252(d).

CONCLUSION

For all of the foregoing reasons as well as those articulated in TW Comm's initial comments in this proceeding, TW Comm respectfully urges the Commission to adopt comprehensive nationally uniform rules to implement Sections 251 and 252 of the Communications Act, consistent with the recommendations set forth herein and in TW Comm's initial comments.

Respectfully submitted,

TIME WARNER COMMUNICATIONS HOLDINGS, INC.

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Date: May 30, 1996
39978.1

CERTIFICATE OF SERVICE

I, Antoinette R. Mebane, a secretary at the law firm of Fleischman and Walsh, L.L.P., hereby certify that a copy of the foregoing "Reply Comments of the Time Warner Communications Holdings, Inc." in CC Docket No. 96-98, was served this 30th day of May, 1996, via hand delivery, upon the following:

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39978.1

ATTACHMENT 1

NEWS

TIME WARNER CABLE

FOR IMMEDIATE RELEASE
May 23, 1996

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Time Warner Says Ameritech Deal with MFS Will Not Satisfy Competitive Checklist Requirement

Time Warner Communications said today that the interconnection agreement between Ameritech and MFS Communications announced yesterday will not satisfy the new Telecommunications Act requirements to enable Ameritech to offer long distance service.

"Before a regional bell operating company (RBOC) such as Ameritech can offer long-distance service, it must have true competition from facilities-based providers in both residential and business markets," said Marsha Schermer, Time Warner Communications vice president of regulatory affairs for the Midwest region. "The interconnection agreement announced yesterday may suit MFS, but it doesn't come near offering local telephone customers the types of choices for service envisioned by the Statute's checklist for competition," she added.

Schermer said Ameritech has an opportunity to reach an interconnection agreement with Time Warner that could be a national model for effective competition. "Time Warner wants to provide facilities-based local telephone competition in the Ameritech region. It is the ideal opportunity for Ameritech to reach an agreement that would provide business and residential consumers a real choice in local telephone service and, at the same time, satisfy the federal requirements Ameritech must meet before it can offer long distance service," said Schermer.

-- more--

Time Warner has been negotiating with Ameritech for more than a year in an attempt to reach an interconnection agreement in Ohio where Time Warner wants to provide local telephone service in 37 counties. "Even with the incentive of the competitive checklist requirement, any progress in our negotiations with Ameritech has been due to prodding by state regulators and legislators," stated Schermer. "And the fact is, after nearly 18 months of negotiations we still do not have an agreement. So far, Ameritech has been successful in choosing its competitors by the way it handles interconnection negotiations which means the market is still closed and Ameritech is the gatekeeper."

Schermer said that the intent of Congress was to make sure that competition exists from companies that have their own facilities. "Without facilities-based competition, the RBOC is both the wholesaler and the retailer which is not a true competitive environment," she said.

Time Warner has been frustrated in its attempts to offer telephone service in Ohio. The company filed its application with the Public Utilities Commission of Ohio (PUCO) in October 1994 to provide local telephone service in 37 Ohio counties. It cannot offer service until it reaches an interconnection agreement with Ameritech and the PUCO issues its competitive rule-making.

The company currently offers local telephone service in Rochester and New York City, NY and has applications pending or approved in several other states.

Time Warner Communications is a division of Time Warner Cable that is leading the company's entry into the telephone business. It currently operates competitive access telephone service in 18 locations across the country. Time Warner Cable is the nation's second largest cable operator, serving 11.7 million customers in 37 states. It is a unit of Time Warner Entertainment Company, L.P.

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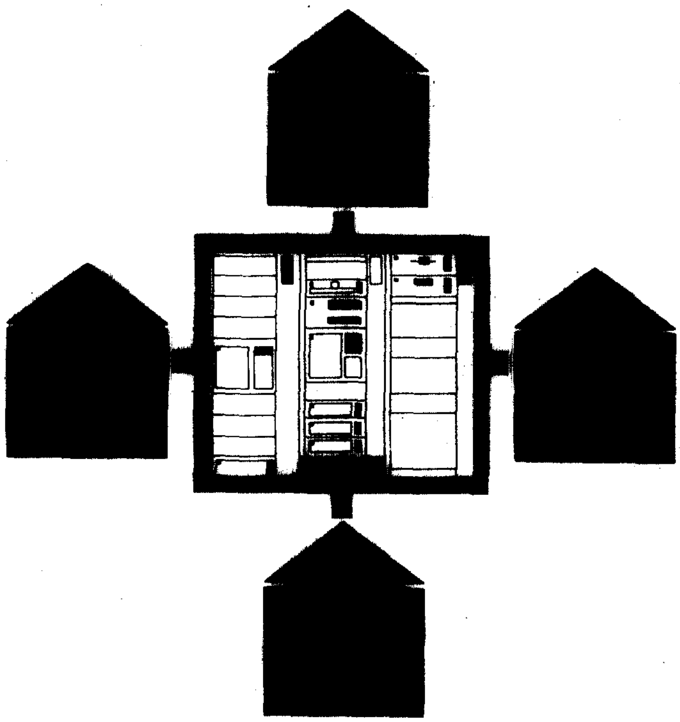
ATTACHMENT 2

STRANDED INVESTMENT
AND THE
NEW REGULATORY BARGAIN



A Time Warner Communications Inc.

Telecommunications Policy White Paper

TIME WARNER
COMMUNICATIONS

"STRANDED INVESTMENT" AND THE "NEW REGULATORY BARGAIN"

A Time Warner Communications, Inc. Telecommunications Policy White Paper*

This is the second in a series of Time Warner Communications, Inc. white papers on current issues of national telecommunications policy. Incumbent local telephone companies argue that if competition in the local service market causes them to lose market share, they somehow have an entitlement to be "made whole." They reason that such revenue erosion prevents them from recovering prior investments ostensibly made in compliance with franchise obligations to provide service. Such claims presuppose some linkage between all prior LEC investments and the obligation to serve, whereas many acquisitions — and particularly the more recent ones — may well have been driven more by competitive aspirations and strategic concerns than by traditional franchise requirements. Even if the value of individual LEC capital assets may have eroded, the persistence of premium (relative to book value) prices for LEC shares confirm that investors view the potential opportunities available through competition and reduced regulation as more than offsetting any erosion in the value of individual assets. The notion of stranded investment also presupposes LEC loss of market share at a pace greater than that required to repay existing investment. However, the history of market share erosion in the competitive telecommunications market belies this claim. Accordingly, a "make whole" policy is neither required nor appropriate, and the adoption of any such program will serve only to increase the already formidable economic barriers to effective local competition.

-- Paul B. Jones, Senior Vice President, Regulatory and Public Policy, Time Warner Communications

* This *Time Warner Telecommunications Policy White Paper* has been prepared with the assistance of Dr. Lee L. Selwyn, President of Economics and Technology, Inc., Boston, Massachusetts 02108.

The "stranded investment" issue

LECs argue that the potential loss of market share to competing local carriers will reduce occupancy/utilization of their subscriber outside plant and other elements of the embedded infrastructure. The result, they reason, is that competition will make it more difficult for them to be assured of recovery of their investment. The foundation of this argument is the LECs' contention that the subject assets were sized and acquired based upon an expectation of continued monopoly provision of local services, and that if competition is permitted to enter the local market the LECs must somehow be "made whole" with respect to the recovery of their investment. The LECs thus invoke the notion of a "regulatory bargain" in which they agreed to forego the opportunity to earn excess monopoly profits in exchange for government (i.e., regulatory) protection of their franchise and assurance of the opportunity to recover their investment and earn a reasonable return on that investment.

Investment that is no longer utilized and for which recovery can no longer be achieved is termed "stranded" — implying that it becomes effectively abandoned as an economic matter. The specific "solution" that LECs offer for the "stranded investment problem" is the establishment of some sort of investment recovery charge to be imposed specifically upon competing local carriers, whom LECs contend are the "cause" of the alleged "stranded investment problem," each time a LEC subscriber is "lost" to the competition. Such a fee, if permitted, will place would-be competitors at a considerable disadvantage by either requiring that customers be charged what amounts to a "penalty" for discontinuing their LEC service, or that the competitor's costs be artificially inflated by the amount of this penalty, if imposed upon it.

The LECs' position is rooted in three theories all of which are fundamentally flawed:

(1) The investments were made in good faith pursuant to the "regulatory bargain" with an expectation of recovery and return, and as such LECs continue to be entitled to such recovery and return on all embedded investment;

(2) Erosion of LEC market shares will occur with such rapidity that LECs will be unable to adjust their cost structure quickly enough to offset revenue losses; and

(3) New entrants are the "cause" of the "stranded investment problem," and as such the new entrants — and they alone — should be made to compensate LECs for these alleged losses.

In the discussion that follows, we will demonstrate, first, that as an economic matter there is no "stranded investment problem" because the aggregate market value of the LEC as a whole is still well in excess of the net book value of its embedded investment; second, that the barriers and customer inertia still confronting potential competitors will not create precipitous market share losses and that in any event LECs have had many years to adjust their costs in anticipation of such losses as might occur; and third, that even if stranded investment were present, the responsibility for its recovery rests either with the LECs' management, with its shareholders, or with the public at large, but in no case with those seeking entry into the local telecommunications market under a newly-established competitive industry paradigm.

There is no "stranded investment" as an economic matter

LECs claim that the sources of the alleged "stranded investment problem" can be traced to (a) failure of regulators to authorize "economic depreciation rates" that would fairly and accurately track the erosion of economic value of LEC plant, and (b) some sort of breach of the "regulatory bargain" in which the LECs' historic monopoly is no longer protected from competitive entry and market share erosion, rendering a portion of the asset base of no economic value because of the drop-off in demand for LEC services. As a consequence of both of these conditions, the economic value of embedded plant, LECs allege, is now below its net book value, entitling the LECs to be made whole for the resulting economic loss.

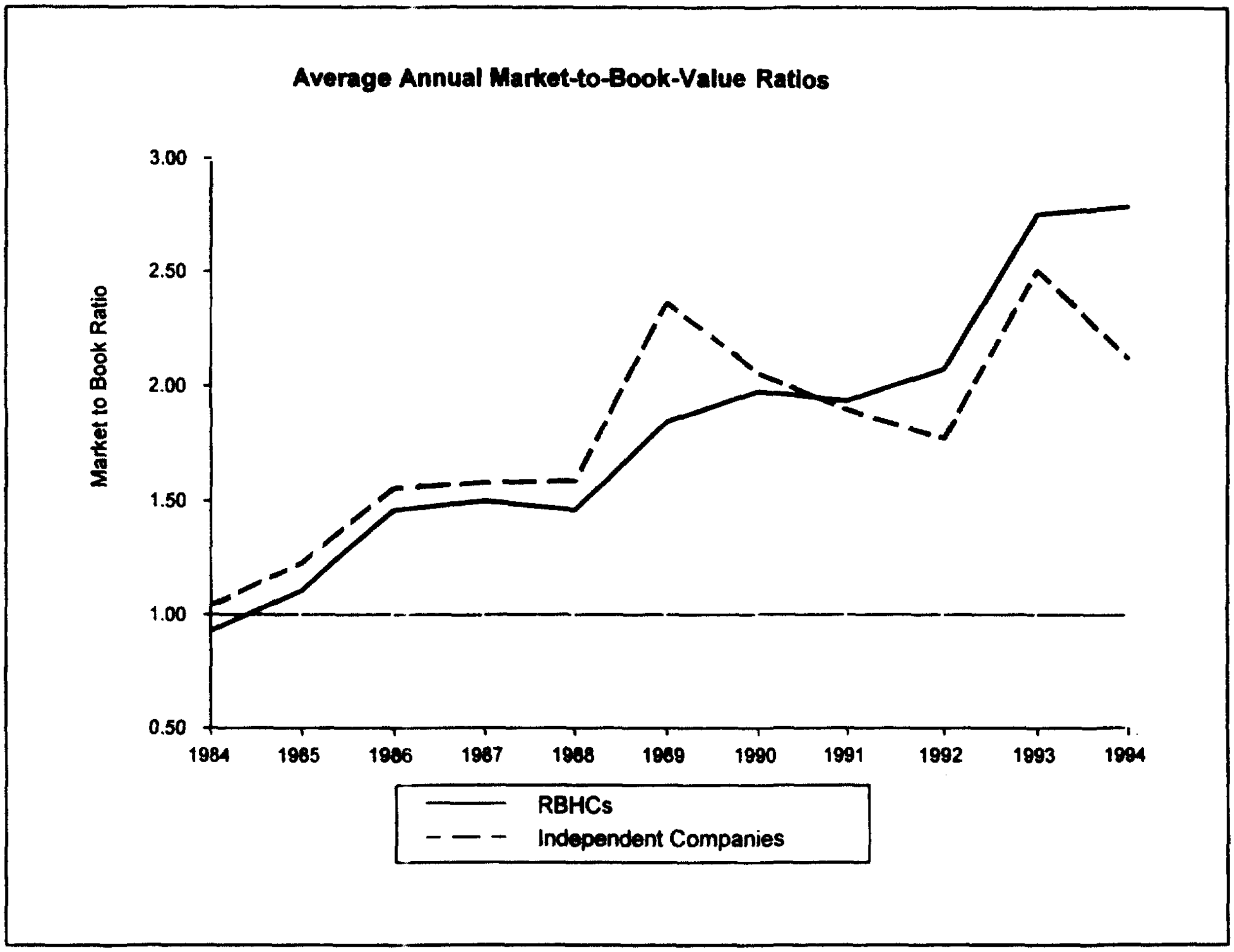
That the economic value of *individual* components of the LECs' infrastructure may have fallen below book value is basically irrelevant if the *aggregation* of all LEC rate base assets continues to possess an economic value in excess of net book value, which is indisputably the case. The equity securities of each of the seven RBHCs are trading well in excess of book value, as is demonstrated in the accompanying table. Moreover, since the break-up of the former Bell System in 1984, the market-to-book value ratios for each of the seven RBHCs has been steadily growing (see figure). Hence the "regulatory bargain" has been fully and indisputably satisfied: LECs and LEC shareholders have not been denied the ability to recover and to earn a fair return on their investment; indeed, LECs and LEC shareholders are today confronted with competitive and other opportunities that Wall Street, at least, is willing to pay a premium over book value to acquire. It is a well-recognized feature of rate of return regulation (which underlies the "regulatory bargain") that investment risks are effectively shifted to and borne by the public as a whole rather than by the shareholders, who are essentially assured full recovery and return. Thus, if the "regulatory bargain" has in fact

LEC Market-to-Book Ratios
as of December 31, 1994

Ameritech	3.6
Bell Atlantic	3.8
Bell South	1.9
NYNEX	1.8
Pacific Telesis	2.6
Southwestern Bell	2.9
US West	2.5
Cincinnati Bell	2.1
SNET	2.2
Rochester Telephone	2.0

Source: *Value Line Investment Survey,* April 14, 1994.

been breached, the breach worked to the detriment of ratepayers who, under "incentive regulation" and other deregulatory programs, may actually be denied the ability to share in the "returns" from the risks that they were required to accept. This relationship between risk and reward is in fact an established principle of traditional rate of return regulation, as confirmed in a landmark 1973 D.C. Circuit Court ruling, in which the court confirmed the principle of "reward follows risk and benefits follow burdens:"[1]



> The ratemaking process involves fundamentally "a balancing of the investor and the consumer interest." The investor's interest lies in the integrity of his investment and a fair opportunity for a reasonable return thereon. The consumer's interest lies in government protection against unreasonable charges for the monopolistic service to

[1] *Democratic Central Committee of D.C. v. Washington Metropolitan Transit Commission*, 485 F2d 786 (D.C. Cir. 1973); *cert. denied*, 415 US 934 (1974).

> which he subscribes. In terms of property value appreciations, the balance is best struck at the point at which the interests of both groups receive maximum accommodation. We think two accepted principles which have served comparably to effect satisfactory adjustments in other aspects of ratemaking can do equal service here.
>
> One is the principle that the right to capital gains on utility assets is tied to the risk of capital losses. The other is the principle that he who bears the financial burden should also reap the benefit resulting therefrom.[2]

The court went on:

> "[T]he cases ... generally agree that consumers have the superior claim to capital gains achieved on depreciable assets while in operation."[3]

Thus, without even getting to the issue of ratepayer entitlement to share in the appreciation in the value of the LEC as a going concern (as reflected in share prices and market-to-book ratios), there can be no dispute that any such gains should at a minimum be used to offset nominal "losses" in the economic value of individual tangible assets. The only place one can find a "stranded investment problem" is by "looking at the LEC from five feet." When viewed as an aggregation of tangible and intangible assets, business opportunities and future earnings potential, investors see no "stranded investment problem," and neither should regulators.

LEC management bears full responsibility for any excess plant capacity

Assuming, for purposes of the present discussion, that utilization of its plant has in fact eroded over time, one is still left with the question as to how much of that decrease in utilization can be reasonably attributed to the entry of competing local carriers vs. other causes, such as overbuilding by the LEC itself.[4]

In fact, outside plant utilization levels have been decreasing steadily since the mid-1970s, a fact that has been noted by several state regulatory commissions (including, in particular, the California PUC and the Washington (state) Utilities and Transportation Commission). While a decrease in the rate of plant utilization could be the result of competitive losses, another equally

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[2] *Id.* at 806.

[3] *Id.* at 811.

[4] This is not to suggest that the LEC would have an entitlement to be "made whole" with respect to stranded investment even if its source were determined to be the entry of local competition, a point that is discussed further below.

plausible explanation might be excessive plant construction by the LEC itself. In that regard, and long before competition for local exchange services surfaced as an issue, LECs were confronting competition for their Centrex service offerings from PBX systems physically located on customer premises. Centrex service typically requires one loop (twisted pair) for each station line, whereas a PBX requires one loop for each PBX trunk and, because the PBX switch effectively concentrates traffic from many station lines onto a relatively small number of central office loops, there are usually far fewer PBX trunks supporting a customer premises PBX than there are station lines in an equivalent Centrex configuration. The PBX station:trunk ratio is typically in the range of 8:1 to 12:1, depending upon overall system size and traffic patterns.

In order to remain competitive in the Centrex market, LECs have apparently specified and deployed maximum density outside plant configurations at potential Centrex sites, even though only a small fraction of customers at these locations actually subscribe to Centrex service. For example, in 1983, the California PUC found that Pacific Bell's plant utilization was inappropriately low, and imposed an explicit "underutilization penalty" on the Company that was to remain in effect until the problem was corrected.[5] This phenomenon of underutilization occurred throughout the Bell system. In the mid-1970s, the average loop plant utilization for the Bell System companies was reported in the 70% range.[6] The loop plant utilization reported by Pacific Northwest Bell — Washington (now US West Communications, Inc.) declined from 69.9% in 1975 to only 60.8% in 1988.[7] In a study undertaken by Economics and Technology, Inc. for the Washington Utilities and Transportation Commission (WUTC), ETI found that the low plant utilization rates present in Washington State could be explained by the precipitous drop in the demand for Centrex service that began shortly after 1980.[8]

ETI noted in the WUTC study that outside plant utilization levels would have remained essentially constant had the demand for Centrex (relative to PBX trunks) remained at pre-1980 levels. ETI speculated that the LEC in that state had continued to construct subscriber outside plant assuming that the same loop demand density would persist. Thus, the LEC continued to deploy plant to serve new commercial development *on the basis that at some point a customer at that business location would want to order Centrex.* This policy, of course, resulted in large

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5 California Public Utilities Commission, D.83-12-025, 13 CPUC 2d, at 479.

6 *See* Selwyn, Lee L., Patricia D. Kravtin, and Paul S. Keller, "An Analysis of Outside Plant Provisioning and Utilization Practices of US West Communications in the State of Washington," prepared for the Washington Utilities and Transportation Commission, March, 1990, Attachment 8.

7 *Id.*

8 *Id.* at 9.

quantities of unused ("spare") outside plant, whose costs would have to be spread to other services.[9]

If the decrease in outside plant utilization is principally or entirely the result either of excessive construction of facilities motivated by some specific marketing goal or simply the result of mis-forecasting by the LEC, there is no basis whatsoever for ascribing any linkage between the onset of local competition and the formation of "stranded investment."[10]

Low outside plant utilization may also be the result of woefully inadequate outside plant recordkeeping, which has historically been done manually rather than using computerized data bases. LECs may not know the precise status of individual pairs — i.e., whether they are in service or spare. In one visit to a downtown San Francisco wire center in the mid-1980s, a Pacific Bell plant foreman advised that roughly 10% of the time a loop pair that had been believed to be available turned out to be in use when the craftsman actually attempted to connect that pair to a (private line) service that was in the process of being installed.[11] To the extent that this situation is representative (and there is reason to believe that it may well be), low plant utilization could also be explained by poor inventory management — LECs may be adding more loop plant simply because they don't have any idea as to which existing loop plant can be used for inward movement.

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9 *Id.* at 22.

10 This possibility can in fact be tested by examining historical information regarding outside plant utilization rates. Among the specific facts that should be elicited are annual data over 10- to 20-year time frame providing:

- Total feeder pairs in place
- Total feeder pairs terminating at central offices
- Total feeder pairs in service
- Distribution plant fill ratios (in whatever form they are maintained)
- Gross pairs added during year
- Pairs replaced/retired/found defective during year
- Inward movement, lines in service by class of service, during year
- Outward movement, lines in service by class of service, during year

In addition, comparisons of forecast requirements with actuals over the same 10- to 20-year time frame would also permit an assessment of management's responsibility for unused capacity. Such an analysis undertaken in several recent proceedings in Massachusetts and Connecticut demonstrated that, particularly for new services, the Company's forecasts were grossly optimistic relative to actual sales, with the latter often running at less than 20% of the former. *See*, Direct Testimony of Lee L. Selwyn on behalf of Scott Harshbarger, Attorney General of the Commonwealth of Massachusetts, Docket No. 94-50, September 14, 1994, and *"A Roadmap to the Information Age: Defining a Rational Telecommunications Plan for Connecticut"*, Docket 91-10-06, Prepared by ETI for the State of Connecticut Office of Consumer Counsel, October 30, 1992.

11 Direct Testimony of Lee L. Selwyn, CA PUC, A.59849, March 26, 1982.

LEC management has an ongoing obligation to act in an efficient and prudent manner in their acquisition and management of telecommunications assets. Even if there were some basis for imposing the costs of "stranded investment" upon ratepayers, competitors, or both, which of course there is not, one would first have to establish that such (now excessive) capacity was prudently acquired and managed, and was not motivated by strategic competitive concerns.[12]

The onset of local competition was a reasonable expectation, and should have been reflected in LEC construction planning

Competition in the US telecommunications market did not happen overnight or instantly; it has been an evolving focus of US telecommunications policy for more than two decades. It is entirely reasonable for regulators to expect that LECs will adjust for the onset of competition in their construction plans and programs. It is reasonable for LECs to expect at least some loss of market share when competition enters the market; if a loss of local exchange market share reduces the overall demand for outside plant and other fixed LEC resources, the LECs should have been responsible for forecasting the changing industry climate and adjusting their plant construction programs for its potential effects. Hence, even where "stranded investment" can be directly associated with a loss of local service market share, had such a loss been correctly anticipated and forecasted by the LEC, it could have reduced its construction program by planning to reuse plant released from service by departing customers.

LEC local exchange rates — particularly those applicable for residential service — are typically set at or below long run incremental cost.[13] In the long run, the avoided incremental costs attributable to market share losses should, if anything, equal or even exceed the loss of revenue for these services; hence, in the long run, there should be no net loss or earnings shortfall when services priced below cost are "lost" to competitors. In the short run, of course, such costs

[12] This type of concern is not limited to the historic past. Current LEC "broadband/video" initiatives involve the construction of massive infrastructure upgrades, a significant portion of which LECs are seeking to ascribe to ongoing basic "voice" telephony. If the revenues that LECs may be forecasting for these new services fail to materialize either because of a lack of demand and/or lower market prices due to the competition from other suppliers, a new "stranded investment" problem will arise in the future. It is for this reason that regulators must make it clear to LECs at the outset that all such investments are entirely at shareholder risk and that LECs should not count on the "core" voice telephony business as a cushion to protect against losses that may arise in the future.

[13] This "below cost" condition generally applies only to the "dial tone line" rate element itself, not necessarily to the total package of services that is furnished to typical residential subscribers. Most customers utilize more than a "stripped-down" dial tone line, and take numerous other services that are priced well in excess of their respective incremental cost. These include such vertical features as touch tone calling, call waiting, unlisted numbers, and other "custom calling" services, and local, toll, and long distance network access usage.

are typically not avoidable, so some net revenue loss would presumably be experienced. However, if the LEC had been adjusting its construction program to account for such competitive losses, it would today be tracking long run costs rather than short run costs, and would not suffer earnings erosion.

Any competitive losses that may occur will be sufficiently gradual so as to afford LECs an ample opportunity to make whatever adjustments to their cost structure that the new market reality may necessitate

Incumbent LECs also caution that the development and growth of competition at the local level will be so rapid as to make it impossible for them to shed costs as rapidly as they will be required to absorb revenue losses. The history of competition in the telecommunications industry belies these fears. AT&T's loss of share of the interLATA long distance market developed slowly in the years since the break-up of the former Bell System. In fact, although AT&T's current market share is in the 60% range, in absolute terms AT&T's aggregate volume of business has steadily *increased* over that same period. Growth in demand for interstate long distance calling averaged 10% annually since the divestiture in 1984, an amount that has been more than sufficient to overcome nominal market share erosion. In 1984, AT&T supplied 126-billion interstate switched service minutes of use; in 1994, its 60% share of the interstate long distance market accounted for more than 235-billion minutes, an increase of 86.5% over the 1984 level.

In fact, LEC local service market share erosion will likely occur far more slowly than that experienced by AT&T with respect to long distance services. For one thing, customers electing to switch from the incumbent LEC to another facilities-based provider will be required to undergo a *physical installation* of the new entrant's services at their homes or businesses, involving the installation of new drop wires, network interface equipment and line powering equipment. When a customer changes long distance carrier, no such installation effort is involved; instead, the LEC is simply advised to enter the new primary interexchange carrier (PIC) on the customer's service record so that interLATA calls dialed on a 1+ basis will be routed to the selected IXC. It has been estimated that in 1994 some 30-million customers switched long distance carrier,[14] yet none of these involved a premises visit.

During the period 1984-1994, annual Bell Operating Company gross plant additions — the amount of new capital assets acquired during each year — averaged about 10% of each BOC's total plant in service. Over a five-year time frame, a LEC will on average replace some 50% of

[14] See, *Look what competition did to long distance prices. Now Imagine what competition could do to local telephone rates...*, AT&T Report, 1994.

its plant, an amount that is grossly in excess of even the most optimistic (or pessimistic, from the standpoint of the LECs) predictions of competitive inroads. Even if the loss of demand for LEC services were to occur as the LECs fear, they would still have ample opportunity to adjust their capital spending to accommodate the new market reality.

LECs have no entitlement to be "made whole" with respect to competitive losses

By advancing the "stranded investment" argument, LECs in effect claim an entitlement to some pre-ordained revenue level that is to be maintained irrespective of the relative success of LEC competitors in capturing market share. Such arguments have generally been rejected in the past (for example, the California PUC recently rejected a Pacific Bell claim for some $109-million in anticipated "competitive losses" that it argued would result from the PUC's decision to permit competition for intraLATA toll services). The Commission concluded that:[15]

> Assuring the LECs recovery of competitive losses would undermine the incentive that NRF [the New Regulatory Framework] was intended to create. The $109 million requested by Pacific and the $23.2 million requested by GTEC constitute 2% and 1%, respectively, of each company's current billing base. Compensating for competitive loss would force the LECs' customers to shelter those percentages of toll revenue from competitive risk even after rates are rebalanced, effectively granting the LECs rate cap returns on those revenues. This would be inconsistent with the ratepayer safeguards and LEC incentives established in NRF. Moreover, Pacific's and GTEC's competitors have no captive markets to provide them with a steady revenue stream if they are inefficient. The effect of Pacific's and GTEC's request would be to increase the rates of all of their ratepayers because of the prospect that some ratepayers might choose another toll carrier. This would shift the risk of competition from the LECs to their ratepayers — not a result we expect from NRF.
>
> Therefore, Pacific's and GTEC's requests for compensation for competitive losses are denied.

The LECs' protectionist mindset must be recognized in addressing the "stranded investment problem." Clearly, competition cannot reasonably be expected to develop if the incumbent will always be made whole with respect to competitive losses; the stranded investment argument falls squarely within the scope of this "entitlement" attitude.

[15] California PUC Investigation (I.) 87-11-033 Implementation and Rate Design (IRD) phase, Decision (D.) 94-09-065, September 15, 1994, at 164.

The adoption of "price caps" or other "incentive regulation" programs de-link rates from costs and terminate the "investment recover and return" aspects of the "regulatory bargain."

Even if the "stranded investment" argument had merit under traditional rate of return regulation (RORR), which it does not, the matter should be laid to rest entirely once a LEC becomes subject to the "price cap" form of regulation as is, for example, the situation applicable to Ohio Bell under the alternative regulation plan that was adopted by the Ohio PUC at the end of last year. Under price caps or other forms of incentive regulation, any linkage between rates and costs is, in principle, permanently severed (at least that is the claim advanced by LEC proponents of price cap regulation). The "going in" rate level for a price caps regime is driven principally by the embedded cost revenue requirement of the utility extant at the time that price cap regulation was first adopted. Whatever that revenue requirement may be, it implicitly captures and reflects the revenue requirement associated with plant then in service. In the case of Ohio Bell, there was no local exchange competition in place at the onset of price caps, hence there was no stranded investment that could be attributed to local competition that would have had any effect on the "going in" revenue requirement. Prospectively, Ohio Bell and other price cap LECs will be permitted to adjust their rates (usually annually) by an "annual price cap adjustment factor" equal to the inflation rate less a productivity offset factor. Since that annual adjustment factor is applied initially to the "going in" embedded revenue requirement and subsequently to previously-adjusted incarnations thereof, the presence or absence of any specific amount of stranded plant does not enter the calculation and thus has no direct affect upon the revenue level of the LEC.

The following simple example will illustrate the mechanics of the annual price cap adjustment. If the "going in" revenue requirement is, say, $1-billion and the annual price cap adjustment factor is, say, 3%, the new revenue level at the time of the first annual price cap adjustment will be set at $1.03-billion *notwithstanding the actual utilization of the LEC's physical resources*. In the second year, and again assuming a 3% annual price cap adjustment factor, the new revenue level will be set at $1.06-billion, again irrespective of the level of plant utilization. Once price caps is in place and the cost/revenue linkage is severed, the presence of so-called "stranded investment" does not have any direct bearing upon the level of revenues to which the LEC is entitled. As such, under price caps there are no financial consequences arising from any "stranded investment" problem that may be present, if in fact such a problem exists as a *physical* matter.

The LEC and its regulator did not embark upon incentive regulation with blinders on relative to potential competition; indeed, the introduction and growth of competition is put forth by LECs as one of the justifications for adoption of incentive regulation in the first place. Once put into effect, the incentive program will permit LEC shareholders to benefit from the numerous opportunities that exploding technology, new services, new sources of demand, and the overall growth of the telecommunications market are creating. The risk of loss through erosion of value of individual assets cannot be separated from the substantial gains and opportunities that confront LECs at this time. If and to the extent that any write-offs or write-downs in the value of individual assets are required, LECs subject to incentive regulation are no different than nonregulated firms, and should be required to take the charge against shareholder earnings.

New competitors are not the "cause" of any "stranded investment," and should in no case be required to reimburse the incumbent LECs for such "losses."

The foregoing discussion has amply demonstrated both the lack of any "stranded investment problem" and that, even if such a "problem" were present, no basis for a "make whole" reimbursement can be justified. But even if such a reimbursement were appropriate, which it is not, there is certainly no basis for viewing the new competitive entrant as the "cost causer" and thereby imposing such costs upon the new entrant.

Whatever the "regulatory bargain" may have been, it was entered into by and between the LEC and the public generally, with regulators acting as "contract administrators" in assuring compliance with the terms of the "bargain." The decision to permit entry and thereby to modify or even to abrogate the "regulatory bargain" has been made by the public generally (via regulatory authorities, legislatures, and the courts). Hence, if there is any entitlement on the part of the LEC to be "made whole" with respect to any "damages" that the LEC may have suffered or may in the future suffer as a result of this fundamental change in US telecommunications policy, it is the public generally, and not those who elect to enter the market as competitors, who must accept the burden of defraying such losses.

Presumably, the decision to permit and indeed to pursue policies designed to affirmatively *encourage* entry was made (by the public through its representatives) because it was (and is) expected that competition will better serve the public interest than retention of the traditional regulatory system. Competitors entering the market thus fulfill the goal of such pro-competitive policies, and are certainly not to be penalized for their willingness to risk private capital in such ventures. If competition is broadly beneficial (which is, of course, the premise of pro-competitive telecommunications policies), then *all customers* benefit whether or not a particular customer individually chooses to take service from or do business with a non-LEC provider. The entry of competition is expected to encourage greater efficiency and innovation on the part of the incumbents, and thereby to bring down prices charged by all providers, dominant as well as new entrant. If and to the extent that there is any basis upon which LECs are entitled to be made whole from "stranded investment" losses, which there is not, that responsibility lies with the party who made the "regulatory bargain" in the first place, and that is the public at large. The write-down of under-utilized LEC assets is the mechanism which most appropriately allocates cost since it effectively reduces reported taxable earnings and, therefore, correspondingly also reduces government revenue required to pay for services rendered by government for the benefit of the public at large.

Conclusion: Stranded investment is a "non-issue," and claims therefore should be summarily dismissed.

LEC efforts to saddle competitors or the public at large with the LECs' own economic losses diminish the ability of new entrants to compete with the incumbent, and thus are at odds with current telecommunications policy goals. The new "regulatory bargain" between the public and the dominant LECs is competition in exchange for less regulation, earnings flexibility in exchange for acceptance of risk. There is thus no question that under the "new regulatory bargain" LECs, not competitors and not the public at large, accept the risks and obtain the opportunity to gain from all of their investments and other pursuits, and have no entitlement to be "made whole" by anybody.